

San Diego, CA

Multifamily Housing Update

November 2006

EXECUTIVE SUMMARY

In some areas of the country employment growth that is on par with the national trend is reason to celebrate. Not in San Diego. This metro that has a history of outperforming the national standard, but since the beginning of 2005, employment growth averaged 1.7% versus the national metric of 1.5%.

Recent trends are more troubling. Employment growth cooled to 1.5% in 3Q06, down 20 basis points from the 1H06 rate of 1.7%. Diminishing growth in the low-wage leisure and hospitality sector along with slower construction hiring contributed to the overall growth decline. The insurance industry actually reduced employment by 1.4% in 3Q06.

Despite the slower employment growth rates, the economy still exhibits some vigor. The unemployment rate fell 20 bps year-over-year to 4.1% in 3Q06, 80 bps below the state metric of 4.9%.

RED anticipate the current employment growth slowdown will spillover into 2007. **RED** forecast payroll job growth of 19,000 (1.5%) in 2006 and 17,000 (13%) in 2007.

Occupancy averaged 96.7% in 3Q06, the highest level since 4Q01. Occupancy increased 50 bps from 2Q06 and 20 bps y-o-y, despite sluggish absorption of 446 units from 4Q05 - 2Q06. Absorption in 3Q06 spiked to 873 units, up from the 355 average over the previous four quarters.

Recent success in the multifamily market is largely attributable to the rampant condo conversion activity that reduced apartment inventory by 13,340 units since April 2003. While this trend has certainly slowed, perhaps to a halt, its effect will be long lasting. Reis project that apartment inventories will not return to pre-

conversion levels until sometime after 2010. As a result, Reis project occupancy to reach 96.8% by YE07 and increase further to 97.4% by YE10.

Tight apartment markets and relatively unaffordable home purchase options enabled owners to increase effective rents 4.3% between 3Q05 and 3Q06. Asking rents increased 4.1% as concessions, while low at 2.9% of asking rent, prove difficult to eliminate completely.

Reis project effective rent growth of 4.4% in 2006 and 4.2% in 2007. Given the supply and demand outlook the forecast appears somewhat conservative but not overly so.

Median home prices fell 2.1% for the single family segment and 6.4% for condos, year-over-year in 3Q06. Despite the declines, homeownership affordability remains very low compared to the cost of renting.

According to Reis trade data, cap rates among investor grade units remained unchanged between 2Q06 and 3Q06 at 4.6%. The indexed average cap rate, which includes smaller property trades, indicates an upward cap rate trend from 5.1% to 5.3% over the period. Average property prices increased by nearly \$80,000 in 3Q06, primarily attributable to one large trade priced at \$273,304 per unit.

Market fundamentals are relatively strong, although rent trends are modest given market tightness. Future NOI gains will hinge on effective rent growth as vacancy rates can not trend much lower. Existing assets for sale are priced at a premium and investors are advised to consider development. Therefore, **RED** assigns a rating of "**Develop**" to San Diego until price growth moderates and NOI forces cap rates lower.

SNAP SHOT

	Y-o-y change	Projected 2007
Vacancy (3.3% - 3Q06)	↓ 20bps	↓ 10bps
Effective Rents (\$1,194 - 3Q06)	↑ 4.3%	↑ 4.2%
Cap Rate (5.3% - 3Q06)	↓ 40bps	↔ unch
Employment (1,300.0k - 3Q06)	↑ 19.0k	↑ 17.0k

KEY POINTS

- Vacancy is the sixth lowest among the 50 metro areas tracked by **RED** CAPITAL Research (**RED** 50) at 3.3%. Vacancy fell 20 basis points year-over-year and 50 basis points on a sequential quarter basis.
- Effective rents increased 4.3% to \$1,194 between 3Q05 and 3Q06, outpacing advances in asking rents for the fifth consecutive quarter.
- The median price of a single family home fell 2.1% year-over-year. Condo prices fell 6.4% over the period.
- Cap rates increased 20 basis points quarter-over-quarter to 5.3%. Investor grade trades indicate a stable cap rate environment with yields averaging 4.6%
- Payroll growth averaged 19,000 or 1.5% in 3Q06, moderately slower than the 1.7% growth rate in 1H06.
- **RED** forecast payroll growth of 19,000 in 2006 and 17,000 in 2007.

